

Litigation John Ryan

Hot Underdog

A small shareholder **defeats** a corporation's chairman and CEO for his seat on the board despite a contentious campaign that includes **litigation** over proxy filings



Guy W. Adams

As the Bush-Gore battle for the presidency revealed, litigation may not be the best way to resolve an election. Now, thanks to a savvy investor named Guy Adams, corporate America has received a refined version of that lesson.

Adams, a Los Angeles-based independent financial analyst, recently won a seat on the board of directors of Lone Star Steakhouse and Saloon, a popular restaurant chain headquartered in Wichita, Kan.

How he did so is an unlikely story.

Adams owns just 1,100 shares of Lone Star stock, worth about \$13,000, and does not have deep pockets. Stranger still, the only seat up for election this year on the five-member board belonged to Jamie Coulter, the company's chairman and chief executive

officer, who owns about 2.4 million shares, worth close to \$29 million, and has options covering an additional 2.6 million shares.

Nevertheless, in the July 6 election, known as a proxy contest, Lone Star shareholders voted for dissident candidate Adams over Coulter 10,003,029 to 8,325,009.

"It's precedent-setting," Patrick McGurn, vice president of Rockville, Md.-based Institutional Shareholders Services, which provides proxy voting research for institutional investors, says of Adams' campaign.

Previously, McGurn says, successful dissident candidates either were representatives of large institutional investors or money managers or were very wealthy individual shareholders.

The legal battle that preceded the election was also unusual and far more contentious. Just weeks earlier, Adams, with the help of attorneys from Los Angeles' Quinn Emanuel Urquhart Oliver & Hedges, defeated a Lone Star suit that would have prevented him from running for Coulter's seat.

Although corporations regularly sue dissident candidates in proxy campaigns, McGurn says that Lone Star's use of litigation was unusual in its aggressiveness. The company, he says, went over the top with its discovery requests of Adams and by "pulling people into court."

The Adams-Coulter proxy contest may have been unusual in its bitterness, but it's indicative of a common situation: rocky relations between shareholders and boards of directors. Friction between the two sides tends to increase in times of lowered corporate profits.

Adams' victories in the courtroom and in the shareholder election are important in this context. It's a timely reminder that share-

holders are the owners of companies and that boards of directors can be held accountable for poor performance and bad decisions. Furthermore, it suggests that corporate attempts to subvert shareholder rights through litigation can be disastrous.

"My reason for doing this was, in large part, reputation-building," Adams, 50, says.

A behind-the-scenes investment adviser to wealthy private parties, Adams thought a board seat would help his career, especially if he could help improve an undervalued company.

Lone Star was a logical target. As a shareholder, Adams knew that the value of the company's stock had declined 75 percent, from \$36.25 per share at the end of 1995 to \$9 at the beginning of 2001. (It is now valued at about \$12.) The Standard & Poor's restaurant index rose more than 50 percent during the same period.

Despite Lone Star's poor performance, its board had approved generous executive compensation packages and the repricing of executive stock options. In 2000, for example, the board increased Coulter's salary by 150 percent, from \$300,000 to \$750,000 per year. In the same year, it failed to approve a number of shareholder proposals, such as one to change board terms from three years to one year. Lone Star's actions suggested that the board was captive to Coulter and not at all independent in its decision making.

Adams thought he could run a campaign on these issues. He also targeted Lone Star because large pension plans and institutional investors own 65 percent of its outstanding stock. He could, therefore, campaign for millions of votes in individual meetings with large shareholders.

With the additional help of his Web page

to push his platform and solicit votes, Adams had the ingredients for a cost-effective campaign.

Like a politician testing the waters, Adams met with the California Public Employees' Retirement System and Amalgamated Bank of New York, two large institutional investors in Lone Star, before going ahead with his candidacy. He won the support of both.

"We were of the opinion that the board members did not have shareholders' interests at heart, but their own," Ted White, director of corporate governance at California's retirement system, says.

In February, Adams informed Lone Star of his intent to run for Coulter's seat, as required by company by-laws, and he filed his proxy materials with the Securities and Exchange Commission, as required by federal law.

Around the same time, he began seeking legal counsel because he feared what Lone Star would do. "Litigation is a tool," Adams says. "I knew it was a possibility that they could use it against me."

And Lone Star did. On April 20, the company filed a suit against Adams in federal court in Kansas. The complaint alleged that Adams' proxy filings with the SEC contained misleading information, and Lone Star sought a preliminary injunction to stop his candidacy.

Adams' contacts in the investment community referred him to John Quinn, the renowned name partner of Quinn Emanuel, a 120-attorney business litigation firm.

Chris Tayback, 37, also a partner in the Los Angeles office, took the lead role in the case. The firm agreed to handle it on an essentially pro bono basis: Adams would pay what he could with the hope of later recouping fees from Lone Star.

Tayback says the firm accepted this arrangement because Adams "had a compelling case."

"YOU didn't have to look too hard at the performance of the company to see that," Tayback says. "There was also some appeal to representing the underdog."

Tayback says the heart of the case was Lone Star's allegation that Adams was not the "sole participant" of his proxy campaign, as he had claimed in the SEC proxy filings.

Lone Star alleged that Adams was a "stalking horse" for a larger investor, one that was financing and directing his campaign. Lone Star soon would target its suspects, most notably the California retirement system.

Lone Star also alleged that Adams' mischaracterized the company's golden-parachute contracts in his filings. Adams was crit-

ical of these contracts, which provide severance benefits to senior management.

Adams acknowledged in his filings that the campaign would cost \$30,000, and he later revised the estimate to \$50,000. Lone Star didn't think he could afford this and sought discovery on several matters to prove it.

The company obtained Adams' phone, bank and brokerage account records. It also obtained the court records of Adams' 1999 divorce proceedings and subpoenaed his landlord.

"It was so above and beyond what was required to litigate," Tayback says.

To keep litigation costs down, Tayback and Adams decided on a less-offensive approach. They moved for dismissal of the suit for lack of jurisdiction with the Kansas court, which later rejected the motion.

The "factual battle," as Tayback calls it, was more important "We had nothing to hide. We complied as best as we could with discovery."

Tayback and Adams provided proof that Adams' net worth was not \$77,000, as Lone Star alleged, but more than \$170,000.

More important, Lone Star failed to link a secret funding source to Adams' campaign. Each group or individual targeted by Lone Star either denied such a link in deposition, or signed a declaration on Adams' behalf.

One of those subpoenaed by Lone Star was White. The California retirement system, White says, would never hide its involvement in a campaign.

"Why would we, or anyone, purposely subvert SEC regulations?" he asks. "It stretches the imagination. That's where it just gets ridiculous."

On June 25, a federal judge ruled that Lone Star failed to prove the existence of other participants in Adams' campaign. Marten ordered Adams to correct errors related to his golden-parachute statements, but the ruling was a victory for Adams overall. It allowed him to go ahead with his campaign and didn't invalidate any votes in his favor.

In fact, Lone Star's litigation seemed to backfire. New York-based Proxy Monitor, which provides proxy research and voting services to institutional investors, called attention to Lone Star's suit when it advised shareholders to vote for Adams. "Management's over-the-top response to Mr. Adams' exercise of his ownership rights lends itself to support the dissident's concerns about the board's commitment to an impartial and high-quality decision-making process, not to mention good judgment," its June 28 recommendation states.

Proxy Monitor was not alone. Adams had the support of other influential groups, such

as Institutional Shareholders Services and the Council of Institutional Investors, a Washington, D.C.-based organization.

Investor groups shared a concern that Lone Star used the courtroom to out-expense and intimidate Adams.

White says that Lone Star's tactics were "fairly undemocratic."

"The proxy process is ours as shareholders," he says. "It's our avenue of affecting companies when we see a problem."

Adams says it's both obvious - and unfortunate - that his campaign would have come to an end without John Quinn and Chris Tayback, who provided expert legal services at a deferred cost.

"I can mount a proxy contest for \$50,000, but with litigation the cost is multiples of that," he says. "You need a war chest because of the eventuality of litigation. It's kind of funny in a sad way."

Lone Star's outside counsel, Thomas Fleming of New York's Olshan Grundman Frome Rosenzweig & Wolosky, strongly denies that his client used litigation for any purpose other than to seek corrections in Adams' filings.

Fleming says that the court's ruling on the golden-parachute issue vindicates the suit and was an important victory at the time. He also says that Adams could have avoided much of the litigation by making these corrections earlier.

Fleming does concede, however, that public perception is on Adams' side. "He did a masterful spin job," he says.

Determining the motives behind Lone Star's use of litigation is not only difficult but ultimately less important than its failure as a matter of strategy.

"It's one of the stupidest things I've ever seen management do in a proxy fight," McGurn says. "This is really a cautionary tale for corporate counsel."

Tayback agrees.

"I think there's a good chance it will deter the use of lawsuits," he says. "An election should be decided on its merits and not in the courtroom."